APPENDIX G (Part 2)

This table does not include future interest or future contingent interest payments. For additional information on our debt, lease commitments, and other commitments see Notes 8 and 12 to our consolidated financial statements.

Cash Flows and Expenditures

Year ended December 31, 2003 compared to year ended December 31, 2002

The table below summarizes gross collections for the years indicated (*in thousands*):

	Years Ended December 31,			
	2003	2002	$ Change	% Change
Owned credit card portfolios	$ 172,894	$ 120,965	$ 51,929	42.9%
Owned other consumer loans	6,056	3,423	2,633	76.9
Retained interest	6,819	13,929	(7,110)	(51.0)
Serviced portfolios	4,750	10,491	(5,741)	(54.7)
Gross collections	$ 190,519	$ 148,808	$ 41,711	28.0

We collected $190.5 million during the year ended December 31, 2003 from all portfolios, an increase of $41.7 million, or 28.0%, from the $148.8 million collected during the year ended December 31, 2002. The source of the improvement was approximately $51.7 million from the owned credit card portfolios, $2.9 million in collections from owned other consumer paper portfolios (charged-off unsecured consumer loans and auto loan deficiencies), offset by a decrease in collections on the retained interest of $7.1 million and decreased collections on the serviced portfolios of $5.7 million.

During 2001, we resumed purchasing charged-off unsecured consumer loans and during 2002, we began purchasing auto loan deficiencies. We purchased $6.0 million and $1.9 million in these loans for the year ended December 31, 2003 and 2002, respectively. Collections related to all portfolios of charged-off unsecured consumer loans and auto loan deficiencies amounted to $6.1 million and $3.4 million for each of years ended December 31, 2003 and 2002, respectively.

We currently utilize various business channels for the collection of charged-off credit cards and other receivables. The following table summarizes the gross collections by collection channel (*in thousands*):

	For the Years Ended December 31,			
	2003	2002	$ Change	% Change
Collection sites	$ 118,431	$ 94,997	$ 23,434	24.7%
Legal collections	39,972	27,620	12,352	44.7
Sales	28,071	18,545	9,526	51.4
Other	4,045	7,646	(3,601)	(47.1)

Gross collections	$ 190,519	$ 148,808	$ 41,711	28.0

Cash flows from operations improved $9.3 million from $24.7 million for the year ended December 31, 2002 to $34.0 million for the year ended December 31, 2003. This reflects the 28.0% growth in gross collections, an increase of $41.7 million from the year ended December 31, 2002 to the year ended December 31, 2003 as well as the non-recurring net proceeds from the Litigation Settlement of $7.9 million in the second quarter of 2003.

Our primary investing activity to date has been the purchase of charged-off receivable portfolios. We purchase receivable portfolios directly from issuers; from resellers; and through brokers that represent various sellers. Purchases affect cash flows in two ways. In periods in which we make portfolio purchases, we generally provide ten percent of each portfolio's purchase price (we provided 25.0% of the purchase price for certain non-credit card receivables purchased through the Secured Financing, and 100.0% of the purchase price of other non-credit card portfolios purchased during the year) as our equity contribution. In subsequent periods, recoveries on the purchased portfolios produce cash flow. We carefully evaluate portfolios and bid only on those that meet our selective targeted return profile.

We paid $89.8 million for portfolios purchased during the year ended December 31, 2003, up $27.3 million or 43.7% from the $62.5 million paid during the year ended December 31, 2002. The following table summarizes the purchases we have made by quarter, and the respective purchase prices (*in thousands*):

Quarter	# of Accounts	Face Value	Purchase Price	Average Purchase Price as a Percentage of Face
Q1 2002	331	$ 717,822	$ 13,145	1.83%
Q2 2002	386	514,591	10,478	2.04
Q3 2002	752	981,471	21,002	2.14
Q4 2002	380	591,504	17,900	3.03
Q1 2003	380	589,356	18,802	3.19
Q2 2003	982	1,177,205	26,271	2.23
Q3 2003	341	640,197	19,350	3.02
Q4 2003	332	881,609	25,411	2.88

We have recovered, in excess of revenue recognized on the accretion method, $71.4 million against the combined cost basis of our portfolios and our investment in the retained interest during the year ended December 31, 2003; up 35.9% or $18.9 million from the recoveries of $52.5 million for the year ended December 31, 2002.

The following table summarizes our purchases and related collections per year of purchase, adjusted for put-backs, account recalls and replacements, purchase price rescissions, and the impact of an acquisition in 2000 (*in thousands*):

Year of Purchase	Adjusted Purchase Price	Cumulative Collections Through December 31, 2003	Collections To Date as a Multiple of Purchase Price
2000	$ 6,154	$ 23,987	3.9

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2001	38,199	108,454	2.8
2002	61,525	118,549	1.9
2003	89,403	59,037	0.7
Total	$ 195,281	$ 310,027	1.6

While we have been able to exceed our targeted collections to adjusted purchase price ratio, the impact of pricing pressure may cause this multiple to decline.

The following table summarizes the concentration of our purchases by seller by year for the following periods, adjusted for put-backs, account recalls and replacements, purchase price rescissions, and the impact of an acquisition (*in thousands*):

Concentration of Initial Purchase Cost by Seller

	2003		2002		2001		2000		Total	
	Cost	%	Cost	%	Cost	%	Cost	%	Cost	%
Seller 1	$30,420	33.9%	$20,223	32.3%	$13,222	33.9%	$ –	–%	$ 63,865	32.3%
Seller 2	23,614	26.3	5,214	8.3	2,463	6.3	–	–	31,291	15.8
Seller 3	3,862	4.3	23,463	37.5	2,292	5.9	–	–	29,617	14.9
Seller 4	–	–	3,780	6.1	8,871	22.7	–	–	12,651	6.4
Seller 5	–	–	398	0.6	8,375	21.4	–	–	8,773	4.4
Seller 6	4,773	5.3	–	–	1,167	3.0	–	–	5,940	3.0
Seller 7	–	–	1,218	2.0	–	–	1,397	20.2	2,615	1.3
Seller 8	–	–	–	–	–	–	2,590	37.5	2,590	1.3
Seller 9	–	–	–	–	–	–	1,078	15.6	1,078	0.5
Seller 10	–	–	–	–	–	–	729	10.5	729	0.4
Other	27,165	30.2	8,229	13.2	2,640	6.8	1,117	16.2	39,151	19.7
	89,834	100.0%	62,525	100.0%	39,030	100.0%	6,911	100.0%	198,300	100.0%
Adjustments (A)	(431)		(1,000)		(831)		(757)		(3,019)	
Adjusted Cost	$89,403		$61,525		$38,199		$ 6,154		$195,281	

(A) Adjusted for putbacks, account recalls and replacements, purchase price rescissions, and the impact of an acquisition

Capital expenditures for fixed assets acquired with internal cash flow were $1.0 million for the year ended December 31, 2003. During the year ended December 31, 2003, $0.3 million of additional capital expenditures were acquired through a capital lease.

Net cash arising from financing activities was $23.4 million during the year ended December 31, 2003 as compared to a use of cash in financing activities of $14.2 million during the year ended December 31, 2002. This reflected $85.5 million in repayment of principal during for the year ended December 31, 2003 and was offset by borrowings of $78.2 million during the year ended December 31, 2003 to fund new portfolio purchases. This also reflected the receipt of $30.1 million in net proceeds from our follow-on offering in

the fourth quarter of 2003. The repayment of principal includes the repayment in full of Securitization 99-1 and the Warehouse Facility as discussed in Notes 4 and 8 of the consolidated financial statements. This compares to borrowings of $62.2 million for the year ended December 31, 2002 to fund new portfolio purchases and $79.7 million in repayment of principal during for the year ended December 31, 2002 under our existing portfolio financing facilities.

Year ended December 31, 2002 compared to year ended December 31, 2001

The table below summarizes gross collections for the years indicated (*in thousands*):

	Years Ended December 31,			
	2002	2001	$ Change	% Change
Owned credit card portfolios	$ 120,965	$ 49,178	$ 71,787	146.0%
Owned other consumer loans	3,423	235	3,188	1,356.6
Retained interest	13,929	20,675	(6,746)	(32.6)
Serviced portfolios	10,491	12,963	(2,472)	(19.1)
Gross collections	$ 148,808	$ 83,051	$ 65,757	79.2

We collected $148.8 million during the year ended December 31, 2002 from all portfolios, an increase of $65.8 million, or 79.2%, from the $83.0 million collected during 2001. Collections on owned portfolios increased by approximately $67.9 million or 97% from approximately $70.1 million during the year ended December 31, 2001 to approximately $138.0 million for the year ended December 31, 2002. The source of the improvement was approximately $79.7 million from the Secured Financing Facility portfolios. Offsetting this improvement was a $2.4 million reduction in collections on the 99-1 Securitization, a $1.0 million reduction in collections on the Warehouse Facility, a $1.5 million reduction from wholly owned portfolios, and a $6.7 million reduction in the 98-1 Securitization.

The $67.9 million increase in collections on owned portfolios is offset by approximately $2.5 million in lower collections related to serviced portfolios. During the year ended December 31, 2002, we collected approximately $10.5 million on serviced portfolios compared to approximately $13.0 million during the year ended December 31, 2001. In February 2003, we returned all exhausted receivables to the owner of these portfolios; however, we have retained the servicing rights for receivables placed in the attorney network.

During 2002 and 2001, we resumed purchasing charged-off unsecured consumer loans and auto loan deficiencies. We purchased $1.5 million and $1.0 million in unsecured consumer loans in 2002 and 2001, respectively. Collections related to the unsecured consumer loans amounted to $3.4 million in 2002 and $0.2 million in 2001. We also purchased $0.4 million in auto loan deficiencies in December 2002.

We currently utilize various business channels for the collection of charged-off credit cards and other receivables. The following table summarizes gross collections by collection channel for the years indicated (*in thousands*):

	Years Ended December 31,			
	2002	2001	$ Change	% Change
Collection sites	$ 94,997	$ 64,160	$ 30,837	48.1%
Legal collections	27,620	16,325	11,295	69.2
Sales	18,545	1,768	16,777	948.9
Other	7,646	798	6,848	858.1

Gross collections	$	148,808	$	83,051	$	65,757	79.2

Cash flow from operations improved $15.8 million from $8.9 million for the year ended December 31, 2001 to $24.7 million for the year ended December 31, 2002. First, this reflects the 79.2% growth in total gross collections of $65.8 million from 2001 to 2002. Additionally, we improved our ratio of total cash basis operating expenses and interest to total gross collections from 60% in 2001 to 44% in 2002. The combination of these two trends resulted in the cash from operations increasing from an 11% retention of gross collections in 2001 to a 17% retention in 2002.

Our primary investing activity is the purchase of new receivables portfolios. We purchase receivables portfolios directly from issuers and from resellers as well as from brokers that represent various issuers. Purchases affect cash flows in two ways. In periods in which we make portfolio purchases, we generally provide 10% of each portfolio's purchase price (we provided 25% of the purchase price for certain non-credit card receivables purchased through the Secured Financing, and 100% of the purchase price of other non-credit card portfolios purchased during the year) as our equity contribution. In subsequent periods, recoveries on the purchased portfolios produce cash flow. We carefully evaluate portfolios and bid on only those that meet our selective targeted return profile.

We purchased $62.5 million in new receivables during the year ended December 31, 2002, up $23.5 million or 60.1% from the $39.0 million purchased during 2001. In addition, we recovered $51.2 million in collections against the cost basis of our portfolios and our investment in the retained interest in 2002; up $34.8 million, or 212.2%, from the recoveries of $16.4 million of recoveries during 2001.

Capital expenditures for fixed assets and capital leases were $0.7 million for the year ended December 31, 2002 compared to $0.4 million for the year ended December 31, 2001. During the years ended December 31, 2002 and December 31, 2001, all purchases of capital expenditures were funded with internal cash flow.

Net cash used in financing activities was $14.2 million for the year ended December 31, 2002, compared to $13.4 million provided by financing activities during the year ended December 31, 2001. This reflected $79.8 million in repayment of principal in 2002 under our existing portfolio financing facilities, which was partially offset by borrowings of $62.2 million in 2002 used to fund new portfolio purchases. These compare to borrowings of $28.9 million in 2001 to fund new portfolios purchases and $14.4 million in repayment of principal in 2001 under our existing portfolio financing facilities.

In addition, we obtained net proceeds of $4.6 million from the sale of the Series A Convertible Preferred Stock during 2002.

Inflation
We believe that inflation has not had a material impact on our results of operations for the three years ended December 31, 2003, 2002 and 2001 since inflation rates generally remained at relatively low levels.

Critical Accounting Policies
Investment in Receivable Portfolios We account for our investment in receivables portfolios on the "accrual basis" or "cost recovery method" of accounting in accordance with the provisions of the AICPA's Practice Bulletin 6, "Amortization of Discounts on Certain Acquired Loans." Static pools are established with accounts having similar attributes, based on the specific seller and timing of acquisition. Once a static pool is established, the receivables are permanently assigned to the pool. The discount (i.e., the difference between the cost of each static pool and the related aggregate contractual receivable balance) is not recorded because the Company expects to collect a relatively small percentage of each static pool's contractual receivable balance. As a result, receivable portfolios are recorded at cost at the time of acquisition.

We account for each static pool as a unit for the economic life of the pool (similar to one loan) for recognition of revenue from receivables portfolios, for collections applied to principal of receivables portfolios and for provision for loss or impairment. Revenue from receivables portfolios is accrued based on the effective interest rate determined for each pool applied to each pool's original cost

basis. Each pool's cost basis is increased for revenue earned and decreased for collections and impairments. The effective interest rate is the internal rate of return determined based on the timing and amounts of actual cash received and anticipated future cash flow projections for each pool.

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We monitor and evaluate actual and projected cash flows for each receivable portfolio on a quarterly basis. Through September 30, 2003, we had not increased the total estimated cash flows for any receivable portfolio. As a result, for those portfolios whose actual cumulative collections exceeded the forecast, such excess amounts were subtracted from the future estimated collections in order to maintain the original forecast. However, effective October 1, 2003, we implemented new collection forecasts utilizing a newly developed forecasting model, the Unified Collection Score ("UCS") that considers known data about our customers' accounts, including, among other things, our collection experience, and changes in external customer factors, in addition to all data known when we acquired the accounts. The effect of our change in estimated projected collections resulting from the implementation of the UCS model is discussed at Note 5 in the consolidated financial statements.

We have historically reduced the total forecasted cash flows on certain receivable portfolios where actual cumulative collections to date have not met the forecast. If the remaining forecasted cash flows are in excess of the remaining carrying value, the effective interest is reduced prospectively. If the remaining forecasted cash flows are less than the remaining carrying value, the receivable portfolio is impaired and all of the remaining collections are subsequently applied against book value. Additionally, if the amount and timing of future cash collections are not reasonably estimable, we accounts for these portfolios on the cost recovery method ("Cost Recovery Portfolios").

Collections realized after the net book value of a portfolio has been fully recovered ("Zero Basis Portfolios") are recorded as revenue ("Zero Basis Income").

Contingent Interest Under the terms of the our Secured Financing Facility, once we repay the lender for the notes for each purchased portfolio and collect sufficient amounts to recoup its initial cash investment in each purchased portfolio, then we share the residual collections ("Contingent Interest") from the receivables portfolios, net of its servicing fees, with the lender. We make estimates with respect to the timing and amount of collections of future cash flows from these receivables portfolios. Based on these estimates, we record a portion of the estimated future profit sharing obligation as Contingent Interest Expense (see Note 8 to the consolidated financial statements).

Deferred Court Costs We contract with a network that acts as a clearinghouse to place accounts for collection with attorneys with whom we contract in most of the 50 states. We generally refer charged-off accounts to our contracted attorneys when we believe the related debtor has sufficient assets to repay the indebtedness and has to date been unwilling to pay. In connection with our agreements with our contracted attorneys, we advance certain out-of-pocket court costs ("Deferred Court Costs"). We capitalize these costs in our consolidated financial statements and provide a reserve for those costs that we believe will be ultimately uncollectible. We determine the reserve based on our analysis of court costs that have been advanced, recovered, and anticipate recovering.

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Income Taxes We use the liability method of accounting for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." Deferred income taxes are recognized based on the differences between financial statement and income tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to

be realized (see Note 9 to the consolidated financial statements).

We utilize estimates in the calculation of our current federal and state income tax liabilities. In our industry, such estimates are subject to substantial interpretation. To the extent federal and state taxing authorities successfully challenge our estimates, we may be required to accelerate the recognition of our revenues or decelerate the recognition of certain expenses for income tax reporting purposes. As a result, we may be required to pay income taxes in periods earlier than we currently expect. Revisions to the estimates would not generally result in a material change in the income tax expense we record in our consolidated financial statements. Instead, it would increase or decrease the amount of taxes we currently are required to pay, which would result in a corresponding increase or decrease in the net deferred asset we have reflected in our consolidated statement of financial condition.

New Accounting Pronouncements

In January 2003, the AICPA issued Statement of Position 03-03 ("SOP 03-03"), "Accounting for Certain Debt Securities Acquired in a Transfer." SOP 03-03 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. This SOP limits the yield that may be accreted (accretable yield) to the excess of the investor's estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the investor's initial investment in the loan. This SOP requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable difference) not be recognized as an adjustment of yield, loss accrual, or valuation allowance. This SOP prohibits investors from displaying accretable yield and nonaccretable difference in the balance sheet. Subsequent increases in cash flows expected to be collected generally would be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected would be recognized as impairment. SOP 03-03 is effective in fiscal years beginning after December 15, 2004, and accordingly, the we expect to adopt the provisions of this SOP in the first quarter of 2005. We do not believe that the implementation of SOP 03-03 will have a material effect on our consolidated financial statements.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity," which establishes standards for the classification and measurement of certain financial instruments with characteristics of both liability and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective for us on July 1, 2003. The adoption of SFAS No. 150 did not have a material effect on our consolidated financial statements.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," which amends and clarifies financial accounting and reporting for derivative instruments. The implementation of SFAS No. 149 did not have a material impact on our consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities." The adoption of FIN 46 did not have a material impact on our consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure – an Amendment to SFAS No. 123." SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method on accounting for stock-based employee compensation. We have retained our accounting for stock based employee compensation under APB No. 25 and have only adopted the pro forma disclosure requirements of SFAS No. 123. Accordingly, the implementation of SFAS No. 148 did not have a material effect on our consolidated financial statements.

In November 2002, the FASB issued Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." The interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also requires a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. In general, the interpretation applies to contract or indemnification agreements that contingently require the guarantor to make payments to the guaranteed party based on changes in an underlying obligation that is related to an asset, liability or an equity security of the guaranteed party. The adoption of FIN 45 did not have a material impact on our consolidated financial statements.

Special Note on Forward-Looking Statements

This report contains "forward-looking statements" within the meaning of the federal securities laws. All statements, other than statements of historical facts, included or incorporated into this Form 10K are forward-looking statements. The words "believe," "expect," "anticipate," "estimate," "project," and similar expressions often characterize forward-looking statements. These statements may include, but are not limited to, projections of collections, revenues, income or loss, estimates of capital expenditures, plans for future operations, products or services, and financing needs or plans, as well as assumptions relating to these matters. These statements include, among others, statements found under "Risk Factors", "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business."

Actual results could differ materially from those contained in the forward-looking statements due to a number of factors, some of which are beyond our control. Factors that could affect our results and cause them to differ from those contained in the forward-looking statements include:

- our ability to purchase receivables portfolios on acceptable terms;
- the availability and cost of financing;
- our ability to recover sufficient amounts on receivables to fund operations;
- our continued servicing of receivables in our third party financing transactions;
- our ability to hire and retain qualified personnel to recover on our receivables efficiently;
- changes in, or failure to comply with, government regulations; and
- the costs, uncertainties and other effects of legal and administrative proceedings.

Forward-looking statements speak only as of the date the statement was made. They are inherently subject to risks and uncertainties, some of which we cannot predict or quantify. Future events and actual results could differ materially from the forward-looking statements. When considering each forward-looking statement, you should keep in mind the risk factors and cautionary statements found throughout this prospectus and specifically those found above. We are not obligated to publicly update or revise any forward looking statements, whether as a result of new information, future events, or for any other reason.

In addition, it is our policy generally not to make any specific projections as to future earnings, and we do not endorse projections regarding future performance that may be made by third parties.

Risk Factors

We may not be able to purchase receivables at sufficiently favorable prices, terms, or quantities for us to be successful.

Our long-term success depends upon the continued availability of receivables for purchase on a cost-effective basis. The availability of receivables portfolios at favorable prices and on favorable terms depends on a number of factors, including:

- the continuation of the current growth and charge-off trends in consumer debt and sales of receivables portfolios by originating institutions;
- our ability to develop and maintain long-term relationships with key major credit originators;
- our ability to obtain adequate data from credit originators or portfolio resellers to appropriately evaluate the collectibility of, and estimate the value of, portfolios; and
- competitive factors affecting potential purchasers and sellers of receivables.

To operate profitably over the long term, we must continually purchase and collect on a sufficient volume of receivables to generate cash collections and the related revenues that exceed our costs.

We depend on a combination of individual portfolio purchases and forward-flow purchase agreements to provide the raw material (charged off receivables) for our collections. Forward-flow purchase contracts have recently begun to represent an increasing proportion of our budgeted purchases. Our current forward-flow contracts are terminable by either the Company or the seller of the receivables on 60 days notice without penalty. There can be no assurance that we will be able to maintain or replace such agreements. In that case, we would be forced to seek alternative sources of charged off receivables, which could take time, be lower quality, cost more, or any combination of these factors, any of which could adversely affect our financial performance.

We may not be able to collect sufficient amounts on our receivables portfolios to recover our costs and fund our operations.

We acquire and service receivables that the obligors have failed to pay and the sellers have deemed uncollectible and written off. The originating institutions generally make numerous attempts to recover on their non-performing receivables, often using a combination of their in-house collection and legal departments as well as third party collection agencies. These receivables are difficult to collect and we may not be successful in collecting amounts sufficient to cover the costs associated with purchasing the receivables and funding our operations.

In addition, our ability to recover on our receivables and produce sufficient returns can be negatively impacted by the quality of the purchased receivables, as well as economic and other conditions outside of our control. Certain receivables we purchase fail to comply with certain terms of the purchase agreements under which they were acquired. Although we seek to return these receivables to the sellers and recover our cost, we are not always successful. We cannot guarantee that such sellers will be able to meet their payment obligations to us. Yields may also be affected by general economic conditions and other events not in our control.

Our industry is highly competitive, and we may be unable to continue to successfully compete with businesses that may have greater resources than we have.

We face competition from a wide range of collection companies and financial services companies which may have substantially greater financial, personnel and other resources, greater adaptability to changing market needs and more established relationships in our industry than we currently have. We also compete with traditional contingency collection agencies and in-house recovery departments. Competitive pressures adversely affect the availability and pricing of charged-off receivables portfolios, as well as the availability and cost of qualified recovery personnel. As there are few significant barriers to entry for new purchasers of charged-off receivables portfolios, we cannot assure you that additional competitors with greater resources than ours will not enter our market. If we are unable to develop and expand our business or adapt to changing market needs as well as our current or future competitors are able to do, we may experience reduced access to charged-off receivables portfolios at appropriate prices and reduced profitability.

Moreover, we cannot assure you that we will be able to continue to offer competitive bids for charged-off receivable portfolios. We face bidding competition in our acquisition of charged-off receivable portfolios. In our industry, successful bids generally are awarded on a combination of price, service, and relationships with the debt sellers. Some of our current and future competitors may have more effective pricing and collection models, greater adaptability to changing market needs, and more established relationships in our industry. They may also pay prices for portfolios that we determine are not reasonable. There can be no assurance that we will continue to offer competitive bids for charged-off consumer receivables portfolios. In addition, there continues to be consolidation of issuers of credit cards, which have been a principal source of receivable purchases. This consolidation has limited the number of sellers in the market and has correspondingly given the remaining sellers increasing market strength in the price and terms of the sale of credit card accounts.

Our failure to purchase sufficient quantities of receivables portfolios may necessitate workforce reductions, which may harm our business.

Because fixed costs, such as certain personnel salaries and lease or other facilities costs, constitute a significant portion of our overhead, if we do not continually augment the receivables portfolios we service with additional receivables portfolios or collect sufficient amounts on receivables owned or serviced by us, we may be required to reduce the number of employees in our collection operations. These practices could lead to:

- lower employee morale, higher employee attrition rates, fewer experienced employees and higher recruiting and training costs;
- disruptions in our operations and loss of efficiency in collection functions; and
- excess costs associated with unused space in collection facilities.

High financing costs currently have an adverse effect on our earnings.

In December 2000, we entered into a $75.0 million Secured Financing Facility to fund portfolio purchases. It provides the lender with interest at a stated rate plus participation in the profits from acquired portfolios. For the year ended December 31, 2003, this arrangement resulted in an effective borrowing rate of 58.3% on portfolio purchases. The facility extends to December 31, 2004 and we cannot terminate it without the lender's approval. Pursuant to an agreement with this lender, we are required to offer this lender the opportunity to finance all purchases of credit card receivables portfolios using this facility. Each note has a maturity date not to exceed 27 months after the borrowing date. This facility limits the earning potential for portfolios we own that are or were financed under it by increasing our costs of borrowing. The sharing in residual cash flows continues for the entire economic life of the receivables portfolios financed using this facility, and will extend substantially beyond the expiration date of the Secured Financing Facility, which is December 31, 2004.

We may be unable to meet our future liquidity requirements.

We depend on both internal and external sources of financing to fund our purchases of receivables portfolios and our operations. Our need for additional financing and capital resources increases dramatically as our business grows. Our inability to obtain financing and capital as needed or on terms acceptable to us would limit our ability to acquire additional receivables portfolios and to operate our business. In particular, we will need to obtain additional financing when our current Secured Financing Facility expires on December 31, 2004. Additional financing, additional capital or sales of certain receivables for cash may also be needed if we are removed as servicer of receivables that are part of our outstanding financings.

We may not be able to continue to satisfy the restrictive covenants in our debt agreements.

Our debt agreements impose a number of restrictive covenants. Failure to satisfy any one of these covenants could result in all or any of the following adverse results:

- acceleration of indebtedness outstanding;
- cross defaults and acceleration of indebtedness under other financing agreements;
- our removal as servicer under our secured financing transactions and possibly other cross-defaulted facilities and loss of servicing fees and other consequences;
- liquidation of the receivables in our secured financing transactions and loss of our expected future excess recoveries on receivables in the financed pools;
- our inability to continue to make purchases of receivables needed to operate our business; or
- our inability to secure alternative financing on favorable terms, if at all.

We use estimates in our accounting and our earnings will be reduced if actual results are less than estimated.

We utilize the interest method to determine revenue recognized on substantially all of our receivables portfolios. Under this method, each pool of receivables is modeled upon its projected cash flows. A yield is then established which, when applied to the outstanding

balance of the receivables, results in the recognition of revenue at a constant yield relative to the remaining balance in the receivables portfolio. The actual amount recovered by us on portfolios may substantially differ from our projections and may be lower than initially projected. If differences are material, then we may reduce our yield, which would negatively affect our earnings, or take a write off on all or a portion of our investment.

Recently, we revised the model we use to forecast collections, which is expected to result in an increase in revenue in future periods. However, we cannot assure that we will achieve the collections forecasted by this model.

We will be required to change how we account for underperforming receivables portfolios, which would have an adverse effect on our earnings.

The American Institute of Certified Public Accountants has issued a Statement of Position ("SOP") 03-03, "Accounting for Loans and Certain Debt Securities Acquired in a Transfer," that revises the accounting standard that governs underperforming receivables portfolios. This SOP is effective for us beginning in the first quarter of 2005. Under the standard, material decreases in expected cash flows would result in an impairment charge to our earnings while the yield we recognize on the receivables portfolio would remain unchanged. However, material increases in expected cash flows will continue to result in a prospective increase in the yield we recognize on a receivables portfolio.

The estimates we use to calculate our income tax may be challenged resulting in our paying more income taxes.

We utilize estimates in the calculation of our current federal and state income tax liabilities. In our industry, such estimates are subject to substantial interpretation. To the extent federal and state taxing authorities successfully challenge our estimates, we may be required to accelerate the recognition of our revenues or decelerate the recognition of certain of our expenses for income tax reporting purposes. As a result, we may be required to use our financial resources to pay income taxes in periods earlier than we currently expect, which will reduce the funds that would otherwise be available to invest in new receivables portfolios or for other corporate purposes.

We will begin to pay substantial amounts in income taxes as a result of our full utilization of our federal net operating loss carry-forward in 2003.

We have not had to pay Federal income taxes for several years as we have utilized our net operating loss carry-forward to offset our Federal tax liability. As of December 31, 2002, we had an approximate $13.3 million Federal net operating loss carry-forward. In 2003, we fully utilized this carry-forward to partially offset our 2003 Federal tax obligation. As a result, we have begun to pay Federal income taxes at a 34% rate on taxable income requiring us to use a portion of our financial resources to pay Federal income taxes, which will reduce the funds we have available to invest in new receivables portfolios or for other corporate purposes.

We may not be successful at acquiring and collecting on portfolios consisting of new types of receivables.

We may pursue the acquisition of portfolios consisting of assets with which we have little collection experience. We may not be successful in completing any of these acquisitions. Our lack of experience with new types of receivables may cause us to pay too much for these portfolios, which may also result in reduced profitability. Our limited experience in collection of these new types of receivables may result in reduced profitability.

Government regulation may limit our ability to recover and enforce the collection of receivables.

Federal and state laws may limit our ability to recover and enforce receivables regardless of any act or omission on our part. Some laws and regulations applicable to credit card issuers may preclude us from collecting on receivables we purchase where the card issuer failed to comply with applicable federal or state laws in generating or servicing the receivables that we have acquired.

Laws relating to debt collections also directly apply to our business. Additional consumer protection or privacy laws and regulations may be enacted that impose additional restrictions on the collection of receivables. Such new laws may adversely affect our ability to collect on our receivables, which could adversely affect our earnings. Our failure or the failure of the originators of our receivables to

comply with existing or new laws, rules or regulations could limit our ability to recover on receivables, which could reduce our revenues and harm our business.

Because our receivables are generally originated and serviced nationwide, we cannot assure you that the originating lenders have complied with applicable laws and regulations. While receivables acquisition contracts typically contain provisions indemnifying us for losses due to the originating institution's failure to comply with applicable laws and other events, we cannot assure you that any indemnities received from originating institutions will be adequate to protect us from losses on the receivables or liabilities to customers.

We are subject to ongoing risks of litigation, including potential class actions under securities, consumer credit, collections and other laws.

We operate in an extremely litigious climate and may be named as defendants in litigation, including in class actions under securities laws as well as consumer credit, collections and various other consumer-oriented laws.

If our future quarterly operating results are below the expectations of securities analysts or investors, the price of our common stock may decline. Stock price fluctuations may be exaggerated if the trading volume of our common stock continues to be low. In the past, securities class action litigation has often been filed against a company after a period of volatility in the market price of its stock.

Defending a lawsuit, regardless of its merit, could be costly and could divert management's attention from the operation of our business. The use of certain collection strategies could be restricted if class action plaintiffs were to prevail in their claims. In addition, insurance costs continue to increase significantly and policy deductibles have also increased. All of these factors could have an adverse effect on our consolidated financial condition and results of operations.

We may make acquisitions that prove unsuccessful or strain or divert our resources.

From time to time, we consider acquisitions of other companies in our industry that could complement our business, including the acquisition of entities in diverse geographic regions and entities offering greater access to businesses and markets that we do not currently serve. We may not be able to successfully acquire other businesses or, if we do, we may not be able to successfully integrate these businesses with our own. Further, acquisitions may place additional constraints on our resources such as diverting the attention of our management from other business concerns. Through acquisitions, we may enter markets in which we have limited or no experience. Moreover, any acquisition may result in a potentially dilutive issuance of equity securities, incurrence of additional debt and amortization of identifiable intangible assets, all of which could reduce our profitability.

Recent legislative actions and proposed regulations will require corporate governance initiatives, which may be difficult and expensive to implement.

To implement required corporate governance initiatives mandated by the Sarbanes-Oxley Act, the Securities and Exchange Commission and the recently adopted Nasdaq rules, we may be required to enhance our internal controls, hire additional personnel and utilize additional outside legal, accounting and advisory services, all of which would cause our general and administrative expenses to substantially increase. We also expect that the premiums we pay for directors' and officers' insurance policies will

increase in the future as a result of higher claim rates incurred by insurers on other insured companies in recent years. These increased costs will adversely affect our operating results.

We may not be able to manage our growth or effectively obtain the resources necessary to achieve additional growth.

We have expanded significantly in recent years and we intend to maintain our growth strategy. However, expanding our operations places great demands on our management, employees, finances and other resources. To successfully manage our growth, we may need to expand and enhance our administrative infrastructure, further improve our management, financial and information systems and controls, and more effectively recruit, train, manage and retain our employees. We cannot assure you that our infrastructure, facilities and personnel will be adequate to support our future operations or to effectively adapt to future growth. If we are unable to effectively manage our growth, it may adversely affect our financial results.

In addition, we believe that the extent of the training we provide to our collections employees makes them attractive targets to our competitors, who may try to solicit them to change jobs.

We may not be able to hire and retain enough sufficiently trained employees to support our operations, and/or we may experience high rates of personnel turnover.

Our industry is very labor intensive. We generally compete for qualified personnel with companies in our business and in the collection agency, tele-services and telemarketing industries. We will not be able to service our receivables effectively, continue our growth and operate profitably if we cannot hire and retain qualified collection personnel. Further, high turnover rate among our employees increases our recruiting and training costs and may limit the number of experienced collection personnel available to service our receivables. Our newer employees tend to be less productive and generally produce the greatest rate of personnel turnover. If the turnover rate among our employees increases, we will have fewer experienced employees available to service our receivables, which will affect our ability to maintain profitable operations.

We depend on our key personnel, the loss of any of whom would adversely affect our operations.

Our performance is substantially dependent on the performance of our senior management and other key personnel. The loss of the services of one or more of our executive officers or key employees, or the inability to hire new management as needed, could disrupt our operations. Although we have employment agreements with two of our senior executives, there can be no assurances that these agreements will assure the continued services of these officers, nor can we assure you that the non-competition provisions of these agreements will be enforceable.

The failure of our technology and phone systems could have an adverse effect on our operations.

Our success depends in large part on sophisticated telecommunications and computer systems. The temporary or permanent loss of our computer and telecommunications equipment and software systems, through casualty, operating malfunction or service provider failure, could disrupt our operations. In the normal course of our business, we must record and process significant amounts of data quickly and accurately to properly bid on prospective acquisitions of receivables portfolios and to access, maintain and expand the databases we use for our collection activities. Any simultaneous failure of both of our information systems and their backup systems would interrupt our business operations.

Our business depends heavily on service provided by various local and long distance telephone companies. A significant increase in telephone service costs or any significant interruption in telephone services could reduce our profitability or disrupt our operations.

We may not be able to successfully anticipate, invest in or adopt technological advances within our industry.

Our business relies on computer and telecommunications technologies and our ability to integrate new technologies into our business is essential to our competitive position and our success. We may not be successful in anticipating, managing, or adopting technological changes on a timely basis. Computer and telecommunications technologies are evolving rapidly and are characterized by short product life cycles.

While we believe that our existing information systems are sufficient to meet our current and foreseeable demands and continued expansion, our future growth may require additional investment in these systems. We depend on having the capital resources necessary to invest in new technologies to acquire and service receivables. We cannot assure you that adequate capital resources will be available to us.

We may not be able to adequately protect the intellectual property rights upon which we rely.

We rely on proprietary software programs and valuation and collection processes and techniques and we believe that these assets provide us with a competitive advantage. We consider our proprietary software, processes and techniques to be trade secrets. We may not be able to adequately protect our technology and data resources.

Our quarterly operating results may fluctuate and cause our stock price to decrease.

Because of the nature of our business, our quarterly operating results may fluctuate in the future, which may adversely affect the market price of our common stock. The reasons our results may fluctuate include:

- the timing and amount of recoveries on our receivables portfolios;
- any charge to earnings resulting from an impairment in the carrying value of our receivables portfolios or in the carrying value of our retained interest;
- increases in operating expenses associated with the growth of our operations; and
- our removal as servicer of our receivables by our Secured Financing Facility provider.

We may not be able to find adequate new facilities in San Diego.

We are currently in the process of searching for a new facility for our San Diego collection site and corporate headquarters. The lease for our current facility expires in October of 2004. We have identified a new building and are in the process of negotiating a lease for this space. There can be no assurance that we can secure a replacement facility at acceptable terms prior to the expiration of our current lease.

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Item 7A – Quantitative and Qualitative Disclosure About Market Risk

Our exposure to market risk relates to interest rate risk associated with our variable rate borrowings. As of December 31, 2003, we had total variable rate borrowings of $39.9 million, all of which consisted of our Secured Financing Facility (see Note 8 to the consolidated financial statements).

Changes in short-term interest rates also affect our earnings as a result of our borrowings under variable rate borrowing agreements. If the market interest rates for our variable rate agreements increase at an average of 10.0%, interest expense would increase, and income before income taxes would decrease by approximately $0.3 million, on an annualized basis, based on the amount of related outstanding borrowings as of December 31, 2003 of $39.9 million. Conversely, if market interest rates decreased an average of 10.0%, our interest expense would decrease, thereby increasing income before income taxes by approximately $0.3 million, on an annualized basis, based on borrowings as of December 31, 2003.

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Item 8 - Consolidated Financial Statements

Encore Capital Group, Inc. Consolidated Financial Statements Years ended December 31, 2003, 2002 and 2001

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Report of Independent Auditors

The Board of Directors and Stockholders
Encore Capital Group, Inc.

We have audited the accompanying consolidated statements of financial condition of Encore Capital Group, Inc., previously known as MCM Capital Group, Inc., and its subsidiaries (the "Company") as of December 31, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity (deficit) and comprehensive income (loss), and cash flows for each of the years in the three year period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Encore Capital Group, Inc. and its subsidiaries as of December 31, 2003 and 2002, and the consolidated results of their operations and their cash flows for each of the years in the three year period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO Seidman, LLP

Costa Mesa, California
February 6, 2004

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Encore Capital Group, Inc.
Consolidated Statements of Financial Condition
(In Thousands, Except Par Value Amounts)

	December 31, 2003	December 31, 2002
Assets		
Cash and cash equivalents	$ 38,612	$ 752
Restricted cash	842	3,105
Investment in receivable portfolios, net *(Notes 5, 6 and 8)*	89,136	64,168
Investment in retained interest *(Note 6)*	1,231	8,256
Property and equipment, net *(Note 7)*	2,786	3,541
Deferred tax asset, net *(Note 9)*	1,358	6,813
Other assets	4,320	3,339
Total assets	$ 138,285	$ 89,974
Liabilities and stockholders' equity		
Accounts payable and accrued liabilities *(Note 8)*	$ 11,644	$ 10,688
Accrued profit sharing arrangement *(Note 8)*	12,749	11,180
Income tax payable *(Note 9)*	883	531
Notes payable and other borrowings, net of discount of zero and $742 as of December 31, 2003 and 2002, respectively *(Note 8)*	41,178	47,689
Capital lease obligations *(Note 12)*	460	344
Total liabilities	66,914	70,432
Commitments and contingencies *(Note 12)*		
Stockholders' equity *(Notes 10 and 11)*:		
Convertible preferred stock, $.01 par value, 5,000 shares authorized, zero shares and 1,000 shares issued and outstanding as of December 31, 2003 and 2002, respectively *(Note 3)*	–	10
Common stock, $.01 par value, 50,000 shares authorized, and 22,003 shares and 7,411 shares issued and outstanding as of December 31, 2003 and 2002, respectively *(Notes 2 and 3)*	220	74
Additional paid-in capital	65,387	31,479
Accumulated earnings (deficit)	5,658	(12,388)
Accumulated other comprehensive income	106	367
Total stockholders' equity	71,371	19,542

Total liabilities and stockholders' equity	$ 138,285	$ 89,974

See accompanying notes to consolidated financial statements

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Encore Capital Group, Inc.
Consolidated Statements of Operations
(In Thousands, Except Per Share Amounts)

	Years ended December 31,		
	2003	**2002**	**2001**
Revenues:			
Revenue from receivable portfolios *(Note5)*	$ 115,575	$ 80,961	$ 32,581
Revenue from retained interest *(Note 6)*	307	5,707	9,806
Servicing fees and other related revenue *(Note 12)*	1,620	3,712	5,458
Total revenues	117,502	90,380	47,845
Operating expenses:			
Salaries and employee benefits	39,286	35,137	27,428
Other operating expenses	11,335	7,934	5,708
Cost of legal collections	15,827	11,028	5,457
General and administrative expenses	6,509	6,314	5,750
Provision for portfolio losses *(Note 5)*	–	1,049	–
Depreciation and amortization *(Note 7)*	2,023	2,453	2,481
Total operating expenses	74,980	63,915	46,824
Income before other income (expense) and income taxes	42,522	26,465	1,021
Other income (expense):			
Interest expense *(Notes 8)*	(20,479)	(18,592)	(10,945)
Other income *(Note 4)*	7,380	213	208
Total other expense	(13,099)	(18,379)	(10,737)
Income (loss) before income taxes	29,423	8,086	(9,716)
(Provision for) benefit from income taxes *(Note 9)*	(11,003)	5,703	(1,149)
Net income (loss)	18,420	13,789	(10,865)
Preferred stock dividends *(Note 3)*	(374)	(440)	–
Net income (loss) available to common stockholders	$ 18,046	$ 13,349	$ (10,865)

Weighted average shares outstanding	10,965	7,339	7,161
Incremental shares from assumed conversion of warrants, options, and preferred stock	9,908	9,120	–
Adjusted weighted average shares outstanding	20,873	16,459	7,161
Earnings (loss) per share – Basic	$ 1.65	$ 1.82	$ (1.52)
Earnings (loss) per share – Diluted	$ 0.88	$ 0.84	$ (1.52)

See accompanying notes to consolidated financial statements

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Encore Capital Group, Inc.

Consolidated Statements of Stockholders' Equity (Deficit) and Comprehensive Income (Loss)

(In Thousands)

	Common Stock		Treasury Stock		Preferred Stock		Additional Paid-In Capital	Accumulated Earnings (Deficit)	Accumulated Other Comprehensive Income	Total
	Shares	Par	Shares	Cost	Shares	Cost				
Balance at December 31, 2000	7,591	$ 76	430	$(128)	–	$ –	$22,082	$(14,872)	$ 2,921	$ 10,079
Net loss	–	–	–	–	–	–	–	(10,865)	–	(10,865)
Other comprehensive loss - decrease in unrealized gain on investment in retained interest, net of tax	–	–	–	–	–	–	–	–	(1,725)	(1,725)
Comprehensive loss	–	–	–	–	–	–	–	–	–	(12,590)
Issuance of common stock warrants *(Note 11)*	–	–	–	–	–	–	153	–	–	153
Treasury stock cancellation	(430)	(4)	(430)	128	–	–	(124)	–	–	–
Balance at December 31, 2001	7,161	72	–	–	–	–	22,111	(25,737)	1,196	(2,358)
Net income	–	–	–	–	–	–	–	13,789	–	13,789
Other comprehensive income - unrealized gain on non-qualified deferred compensation plan assets	–	–	–	–	–	–	–	–	39	39
Other comprehensive loss - decrease in unrealized gain on investment in retained interest, net of tax	–	–	–	–	–	–	–	–	(868)	(868)
Comprehensive income	–	–	–	–	–	–	–	–	–	12,960
Net proceeds from issuance of Preferred Stock *(Note 3)*	–	–	–	–	1,000	10	4,578	–	–	4,588

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Preferred dividends	–	–	–	–	–	–	–	(440)	–	(440)
Forgiveness of debt, net *(Note 3)*	–	–	–	–	–	–	4,665	–	–	4,665
Issuance of common stock warrants *(Note 11)*	–	–	–	–	–	–	125	–	–	125
Exercise of common stock warrants *(Note 11)*	250	2	–	–	–	–	–	–	–	2
Balance at December 31, 2002	7,411	74	–	–	1,000	10	31,479	(12,388)	367	19,542
Net income	–	–	–	–	–	–	–	18,420	–	18,420
Other comprehensive income - unrealized gain on non-qualified deferred compensation plan assets	–	–	–	–	–	–	–	–	46	46
Other comprehensive loss - decrease in unrealized gain on investment in retained interest, net of tax	–	–	–	–	–	–	–	–	(307)	(307)
Comprehensive income										18,159
Preferred dividends	–	–	–	–	–	–	–	(374)	–	(374)
Preferred stock converted to common stock *(Note 3)*	10,000	100	–	–	(1,000)	(10)	(90)	–	–	–
Net proceeds from issuance of common stock *(Note 2)*	3,000	30	–	–	–	–	30,101	–	–	30,131
Exercise of common stock warrants *(Note 11)*	957	10	–	–	–	–	615	–	–	625
Exercise of stock options *(Note 10)*	635	6	–	–	–	–	608	–	–	614
Excess tax benefits related to stock options *(Note 9)*	–	–	–	–	–	–	2,546	–	–	2,546
Amortization of stock options issued at below market *(Note 10)*	–	–	–	–	–	–	128	–	–	128
Balance at December 31, 2003	22,003	$220	–	$ –	–	$ –	$65,387	$ 5,658	$ 106	$ 71,371

See accompanying notes to consolidated financial statements

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Encore Capital Group, Inc.
Consolidated Statements of Cash Flows
(In Thousands)

	Years ended December 31,		
	2003	**2002**	**2001**
Operating activities			

Gross Collections	$ 190,519	$ 148,808	$ 83,051
Proceeds from litigation settlement *(Note 4)*	11,100	–	–
Less:			
Amounts collected on behalf of third parties	(4,750)	(10,494)	(12,963)
Amounts applied to principal on receivable portfolios	(63,374)	(43,423)	(16,398)
Amounts applied to principal of securitization 98-1	(6,512)	(7,808)	–
Litigation settlement proceeds applied to principal of receivable portfolios	(692)	–	–
Legal and other costs related to litigation settlement	(3,198)	–	–
Servicing fees	1,620	3,712	5,398
Operating Expenses			
Salaries and employee benefits	(38,431)	(32,909)	(27,315)
Other operating expenses	(11,044)	(7,800)	(6,096)
Cost of legal collections	(15,827)	(11,028)	(5,457)
General and administrative	(6,303)	(6,707)	(6,162)
Interest payments	(5,222)	(4,146)	(4,817)
Contingent interest payments	(14,455)	(4,246)	–
Other income	295	211	197
Decrease (Increase) in restricted cash	2,263	(52)	(585)
Income taxes	(2,018)	572	–
Net cash provided by operating activities	33,971	24,690	8,853
Investing activities			
Purchases of receivable portfolios	(89,834)	(62,525)	(39,030)
Collections applied to principal of receivable portfolios	63,374	43,423	16,398
Litigation settlement proceeds applied to principal of receivable portfolios	692	–	–
Collections applied to principal of securitization 98-1	6,512	7,808	–
Proceeds from put-backs of receivable portfolios	799	882	1,150
Proceeds from the sale of property and equipment	–	3	137
Purchases of property and equipment	(1,015)	(749)	(428)
Net cash used in investing activities	(19,472)	(11,158)	(21,773)
Financing activities			
Proceeds from notes payable and other borrowings	78,226	62,183	28,936
Repayment of notes payable and other borrowings	(85,478)	(79,669)	(14,440)
Capitalized loan costs relating to financing arrangement	(245)	(154)	(55)
Proceeds from sale of common stock, net *(Note 2)*	30,131	–	–
Proceeds from exercise of common stock options *(Note 10)*	614	–	–
Proceeds from exercise of common stock warrants *(Notes 2 and 11)*	625	2	–
Proceeds from sale of preferred stock *(Note 3)*	–	4,588	–
Payments of preferred dividends	(374)	(250)	–
Repayment of capital lease obligations	(138)	(892)	(997)
Net cash provided by (used in) financing activities	23,361	(14,192)	13,444
Net increase (decrease) in cash	37,860	(660)	524
Cash and cash equivalents, beginning of year	752	1,412	888
Cash and cash equivalents, end of year	$ 38,612	$ 752	$ 1,412

See accompanying notes to consolidated financial statements

Encore Capital Group, Inc.
Consolidated Statements of Cash Flows (continued)
Reconciliation of Net Income (Loss) to Net Cash Provided by Operating Activities
(In Thousands)

	Years ended December 31,		
	2003	2002	2001
Net income (loss)	$ 18,420	$ 13,789	$ (10,865)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	2,023	2,452	2,481
Amortization of loan costs	603	661	1,457
Amortization of debt discount	742	112	146
Amortization of stock based compensation	128	–	–
Gain on sales of property and equipment	–	–	(11)
Deferred income tax expense (benefit)	5,456	(6,234)	1,149
Excess tax benefits from stock options	2,722	–	–
Increase in income on retained interest	–	414	10,816
Increase in income on receivable portfolios	–	–	450
Provision for portfolio losses	–	1,049	–
Changes in operating assets and liabilities			
(Increase) decrease in restricted cash	2,263	(52)	(585)
Increase in other assets	(1,339)	(783)	(1,593)
Note payable issued in lieu of interest payment	–	–	1,308
Increase in accrued profit sharing arrangement	1,569	8,802	2,378
Increase in accounts payable and accrued liabilities	1,384	4,480	1,722
Net cash provided by operating activities	$ 33,971	$ 24,690	$ 8,853
Supplemental schedules of non-cash investing activities:			
Property and equipment acquired under capital leases	$ 253	$ –	$ –
Supplemental schedules of non-cash financing activities:			
Issuance of common stock warrants in connection with debt agreements	$ –	$ 125	$ 153
Recordation of equity in connection with debt forgiveness	$ –	$ 4,665	$ –

See accompanying notes to consolidated financial statements

Note 1: Summary of Significant Accounting Policies

Ownership and Description of Business

Encore Capital Group, Inc. ("Encore") is a systems-driven purchaser and manager of charged-off consumer receivables portfolios. Encore acquires these portfolios at deep discounts from their face values using its proprietary valuation process that is based on the consumer attributes of the underlying accounts. Based upon Encore's ongoing analysis of these accounts, it employs a dynamic mix of collection strategies to maximize its return on investment. Encore is a Delaware holding company whose principal assets are its investments in its wholly-owned subsidiaries, Midland Credit Management, Inc. ("Midland Credit"), Midland Funding 98-A Corporation ("98-A"), Midland Receivables 99-1 Corporation ("99-1"), Midland Acquisition Corporation ("MAC"), MRC Receivables Corporation ("MRC"), Midland Funding NCC-1 Corporation ("NCC-1"), and Midland Funding NCC-2 Corporation ("NCC-2") (collectively referred to herein as the "Company"). Encore also has a wholly owned subsidiary, Midland Receivables 98-1 Corporation, which is not consolidated, but is recorded as an investment in retained interest on the accompanying consolidated statements of financial condition The receivable portfolios consist primarily of charged-off domestic consumer credit card receivables purchased from national financial institutions, major retail credit corporations, and resellers of such portfolios. Acquisitions of receivable portfolios are financed by operations and by borrowings from third parties (see Note 8).

Cash and Cash Equivalents

Cash equivalents consist of highly liquid investments with a maturity of three months or less at the date of purchase. The Company invests its excess cash in bank deposits, money market, and short term commercial debt and auction rate preferred stock and debt securities, which are afforded the highest ratings by nationally recognized rating firms. The carrying amount reported in the balance sheet for cash and cash equivalents approximates its fair value.

Restricted Cash

Restricted cash represents undistributed collections held on behalf of principals. In 2002, restricted cash also included reserve accounts pledged to the Warehouse Securitization and Securitization 99-1 (see Notes 6, 8, and 12).

Investment in Receivable Portfolios

The Company accounts for its investment in receivables portfolios on the "accrual basis" or "cost recovery method" of accounting in accordance with the provisions of the AICPA's Practice Bulletin 6, "Amortization of Discounts on Certain Acquired Loans." Static pools are established with accounts having similar attributes, based on the specific seller and timing of acquisition. Once a static pool is established, the receivables are permanently assigned to the pool. The discount (i.e., the difference between the cost of each static pool and the related aggregate contractual receivable balance) is not recorded because the Company expects to collect a relatively small percentage of each static pool's contractual receivable balance. As a result, receivables portfolios are recorded at cost at the time of acquisition.

The Company accounts for each static pool as a unit for the economic life of the pool (similar to one loan) for recognition of revenue from receivables portfolios, for collections applied to principal of receivables portfolios and for provision for loss or impairment. Revenue from receivables portfolios is accrued based on the effective interest rate determined for each pool applied to each pool's original cost basis. Each pool's cost basis is increased for revenue earned and decreased for collections and impairments. The effective interest rate is the internal rate of return determined based on the timing and amounts of actual cash received and anticipated future cash flow projections for each pool.

The Company monitors and evaluates actual and projected cash flows for each receivable portfolio on a quarterly basis. Through September 30, 2003, the Company had not increased the total estimated cash flows for any receivable portfolio. As a result, for those portfolios whose actual cumulative collections exceeded the forecast, such excess amounts were subtracted from the future estimated collections in order to maintain the original forecast. However, effective October 1, 2003, the Company implemented new collection forecasts utilizing a newly developed forecasting model, the Unified Collection Score ("UCS") that considers known data about the Company's customers' accounts, including, among other things, its collection experience, and changes in external customer factors, in addition to all data known when it acquired the accounts. The effect of the Company's change in estimated projected collections resulting from the implementation of the UCS model is discussed at Note 5.

The Company has historically reduced the total forecasted cash flows on certain receivable portfolios where actual cumulative

collections to date have not met the forecast. If the remaining forecasted cash flows are in excess of the remaining carrying value, the effective interest is reduced prospectively. If the remaining forecasted cash flows are less than the remaining carrying value, the receivable portfolio is impaired and all of the remaining collections are subsequently applied against book value. Additionally, if the amount and timing of future cash collections are not reasonably estimable, the Company accounts for these portfolios on the cost recovery method ("Cost Recovery Portfolios").

Collections realized after the net book value of a portfolio has been fully recovered ("Zero Basis Portfolios") are recorded as revenue ("Zero Basis Income").

Securitization Accounting

In September 2000, the FASB issued SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," that replaces, in its entirety, SFAS No. 125. The accounting treatment prescribed by this pronouncement was effective for fiscal years ending after December 15, 2000 for disclosure purposes. The adoption of this pronouncement did not have a significant impact on the Company's consolidated financial statements.

Retained Interest in Securitized Receivables

From inception in 1999, the Company's investment in retained interest in securitized receivables was treated as a debt security similar to an available-for-sale security and was carried at fair value. At the time of securitization, the retained interest was initially recorded at the basis allocated in accordance with SFAS No. 125. This original cost basis was adjusted to fair value, which was based on the discounted anticipated future cash flows on a "cash out" basis, with such adjustment (net of related deferred income taxes) recorded as a component of other comprehensive income. The cash out method was used to project cash collections to be received only after all amounts owed to investors had been remitted.

Income on the retained interest was accrued based on the effective interest rate applied to its original cost basis, adjusted for accrued interest and principal pay downs. The effective interest rate was the internal rate of return determined based on the timing and amounts of actual cash received and anticipated future cash flow projections for the underlying pool of securitized receivables.

In January 2001, the Emerging Issues Task Force reached a consensus on EITF 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." EITF 99-20 requires companies to account for all changes in forecasted revenues for retained beneficial interests prospectively through a change in the effective interest rate. The Company adopted EITF 99-20 on its effective date, April 1, 2001. Pursuant to EITF 99-20, the retained interest is carried at cost, increased by interest accretion based on estimated future cash receipts and decreased by actual cash collections. The retained interest is estimated to yield a monthly return based on estimated net cash flows derived from historical cash flows. The unrealized gain reflected as a component of stockholders' equity net of tax is recognized in income utilizing the effective interest method (See Note 6).

The Company monitors impairment of the retained interest based on discounted anticipated future cash flows of the underlying receivables compared to the original cost basis of the retained interest, adjusted for unpaid accrued interest and principal pay downs. The discount rate is based on a rate of return, adjusted for specific risk factors that would be expected by an unrelated investor in a similar stream of cash flows. The retained interest is evaluated for impairment by management quarterly based on current market and cash flow assumptions applied to the underlying receivables. Provisions for losses would be charged to earnings when it is determined that the retained interest's original cost basis, adjusted for unpaid accrued interest and principal pay downs, is greater than the present value of expected future cash flows. No provision for impairment has ever been recorded for the retained interest.

The retained interest is held by Midland Credit and the related receivable portfolios are held by a wholly-owned, bankruptcy remote, special purpose subsidiary of the Company, Midland Receivables 98-1 Corporation.